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SUBJECT: PANEL WARNS TURKEY LAGS BEHIND IN ISLAMIC FINANCE

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11. (U) SUMMARY: Representatives from Islamic finance institutions and local law firms met in Istanbul on June 4 for a one-day session on Islamic Finance in Turkey. Osman Akyuz, Secretary General of the Turkish Participation Banks Association, was enthusiastic about the growing strength of "participation banks,8 the Turkish legal term for Shariah-compliant banks. The speakers discussed the strong potential for Islamic banking in Turkey, as well as product development and the unique problems that affect the sector in Turkey. They stressed participation banking is socially responsible because it focuses on the real economy; money does not make money, they maintained, but is used to create social wealth, which should be shared. The overall tone of the conference was optimistic, though several speakers expressed the view that the Government of Turkey (GOT) could do much more to provide regulatory clarity to the sector. They also opined that GOT,s reluctance to embrace Shariah-compliant financial products, such as Sukuk, is stifling Turkey,s ability to capture funds flowing into this market. END SUMMARY.

12. (U) Shariah-compliant banks are known as "participation banks" in Turkey, and in accordance with the Banking Law of 2005 they are under the regulatory umbrella of the Banking Regulatory and Supervisory Agency (BRSA). Modern Islamic banking began in Turkey in 1985 during the presidency of Turgut Ozal (see reftel for a greater background on Turkish Islamic banking). According to Secretary General of the Turkish Participation Banks Association Osman Akyuz, participation banks have about a 5% market share in Turkey, with 4.5% of total Turkish deposits, 5.4% of loans and 3.9% of assets. These figures have generally trended up in recent years, although the share of total loans is down slightly from 2007. The industry has a modest target market share of 10% of total deposits by 2015. Leverage in Turkish participation banks is 7%, compared with 25% in Europe. M. Fatih Bulac from Turkiye Finans boasted that Turkish participation banks can operate smoothly at these low rates due to strict government oversight enacted since Turkey,s financial meltdown in 2001.

13. (U) Modern Shariah-compliant banking is relatively new in both Turkey and the rest of the world, and Islamic capital markets are in their infancy. Nearly all the participants pointed to Shariah-compliant bonds (Sukuk) as a vital means to raise capital. (NOTE: According to an Islamic Finance website, Sukuk financing should only be raised for trading

in, or construction of, specific and identifiable assets. All Sukuk returns and cash flows must be linked to acquired assets, or must be generated from an asset once it is constructed, and not from interest-based income. END NOTE). Despite a number of countries issuing Sukuk bonds -- such as Malaysia and Kuwait -- Turkey is lagging behind in this area, according to all the participants. According to Faruk Sabuncu of PriceWaterhouseCoopers, the BRSA concentrates on conventional banks and the GOT,s failure to mesh its standards and terminology with generally-accepted Islamic practices causes many pious Muslims to be wary of Turkish Shariah-compliant products. For example, the Central Bank did issue Shariah-compliant bonds earlier this year (one in January for USD 330 million and one in April for USD 485 million), but the legislation authorizing these bonds intentionally avoided the word Sukuk due to its religious connotation, which caused many potential customers to question the bonds, Shariah compliance. Moreover, many Islamic scholars, whose imprimatur is required in the issuance of a Sukuk, have labeled these Turkish bonds as non-Shariah compliant. Sabuncu identified the lack of clarity regarding taxation of Islamic financial instruments as another barrier to product development and marketing. Several interlocutors stated that a number of conventional banks in Turkey are very interested in opening an "Islamic window", or in setting up an offshore subsidiary, but are reluctant to do so without government approval. These banks are interested in, inter alia, the issuance of Islamic corporate bonds.

14. (U) The two largest markets for Shariah-compliant products are the Middle East and Malaysia. According to Paul Wouters of the Bener Law Office in Istanbul, Persian Gulf money is

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gravitating to Southeast Asia and Turkey should be attracting some of it through more aggressive marketing. Turkey has strong financial institutions, yet legal barriers create an uneven playing field for Turkish banks trying to "grab this money floating over our heads". Wouters criticized secularists in Turkey for blocking necessary reforms to capture the Islamic market. Non-Muslim majority countries such as France and Luxemburg have enacted legislation to encourage Shariah-compliant banking and financing. Toyota recently started an Islamic auto finance operation in Malaysia, a phenomenon that could potentially be replicated in Turkey. Moreover, Islamic trade finance might hold great growth potential, given Turkey,s large export-import sector. Although capital markets development will probably lag banking in the near term, it is noteworthy that BMD Securities issued the world,s first Islamic exchange traded fund, based on a Dow Jones index that measures the performance of global Islamic bonds. According to Wouters, the Islamic mutual fund sector is USD 50 billion, mostly in equities, but fixed income and money market funds are needed. The industry estimates that global Islamic financial assets, which at present amount to USD one trillion, will grow to USD four trillion over the next five years. Wouters claimed Turkey should realize that it is losing out to non-Islamic nations when it comes to Islamic financing.

15. (U) The participants emphasized that Islamic finance should broaden its customer pool to non-Muslims seeking sound and socially-responsible finance vehicles. Investment opportunities in solid projects, such as ship building or constructing schools, rather than low-quality sub-prime mortgages, would likely attract a diverse group of investors in today,s environment, according to Wouters. Participation banks generally lend up to 95% of their deposit base, mostly in the real sector, although during the current crisis that amount declined to 80-85%. Most of the banks, remaining funds were invested in revenue index bonds, not T-bills or T-bonds. Cenk Karacaoglu of Bank Asya noted that Islamic financial institutions do not view loan pricing as a competitive advantage; rather, service and quality are what distinguish them. Karacaoglu spoke of the "structure and

methodology" of Islamic finance as a differential advantage. Bennar Balkaya, Partner at Balkaya and Balkaya, noted that arbitration in Islamic banking is a good means for keeping business matters confidential. By mutual agreement, parties can agree to settle business disputes through arbitration, thus ensuring that the dispute, and the terms of the contract, remains out of the courts and out of the public eye.

16. (SBU) A strong message from the conference was government aversion to Islamic finance is harming Turkey,s goal to be a financial hub. While Islamic banks hold only about five percent of deposits and loans in Turkey, there are champions of the sector who think Turkey is missing an important opportunity to attract more money from Middle Eastern and strict Islamic customers. The underlining theme from the conferees was that the Islamic-rooted Justice and Development Party (AKP) is reluctant to propose pro-Islamic finance legislation, because of fears of a strong backlash from secularists deeply suspicious of the ruling party,s motivations.

WIENER